In the

United States Court of Appeals
For the Ninth Circuit

HARVEY L. WELLS and HARRY J. ALBERTSEN, on behalf of themselves and others similarly situated, *Appellants,*

vs.

J. C. PENNEY COMPANY, a corporation, and THE CHASE MANHATTAN BANK, a corporation (substituted for The Chase National Bank of the City of New York), *Appellees.*

NO. 15,125

APPELLANTS' REPLY BRIEF

Appeal from Final Judgment of the United States District Court for the District of Oregon.

HONORABLE GUS J. SOLOMON, JUDGE

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I. APPELLEES HAVE FAILED TO SHOW THAT STOCK AWARDS ARE NOT CONTINGENT ON THE LIVES OF PARTICIPANTS.

Nowhere in their brief do Appellees dispute the fact that under the Penney Plan stock awards to retiring participants are increased by the deaths, discharges, and withdrawals of fellow participants. Nor do they dispute that stock purchased by the Trustee at the outset of the Plan (using the contributions, earnings and credit of the then participants) was awarded only to those who survived with the Company to age 60. By failing to dispute these facts, Appellees concede that the sole issue before the court is the legal effect of the Plan. This can be determined from the Plan itself, in which awards of stock are based on three factors: (1) a participant's own contributions, (2) contributions of all participants in the Plan at the moment, and (3) the amount of stock then remaining in the 150,000 (450,000) share block.

II. APPELLEES HAVE FAILED TO SHOW THAT THE PLAN IS NOT CONTRARY TO NEW YORK LAW AND PUBLIC POLICY.

A) Appellees Consistently Misstate the Basic Issue.

Appellees do not deal with the crucial issues raised by Appellants. Instead, they deal with their own repeated misstatements of those issues.

> "Appellants center their * * * charge * * * on the * * * provision that only participants who con-

> tinue in the service of the Company until they reach retirement status will receive shares of Penney Company stock." (Br. for Appellees 4)
>
> "Appellants place major emphasis upon the Plan requirement of continued employment to retirement age in order to receive stock." (Br. for Appellees 34)

Of course the mere fact that service to a particular age is a condition for the award of the retirement benefits does not itself render the Penney Plan illegal. Therefore, the legality of the numerous plans cited by Appellees (Br. for Appellees 18-19) in which benefits are contingent upon certain conditions precedent (age, length of service, etc.) is not challenged by Appellants, and such authorities are quite irrelevant to the illegal features of the Penney Plan.

However, when all the stock to be awarded is purchased at the outset of the Plan by using the contributions and earnings of participants during the first two years and then is awarded only to those who subsequently reach a certain age, that is improper. And when the stock awards made to those fortunate enough to survive with the company to age 60 are swelled every time a fellow participant dies, withdraws or is discharged, that too violates New York law and public policy. Such increases in the stock award to survivors is the *necessary* result from every death, discharge, and withdrawal of a participant, not, as Appellees assert, an "incidental possibility." (Br. for Appellees 40)

B) A Participant's Service Record is Only One of Three Factors Determining His Stock Award.

Appellees suggest that Plan benefits to each participant are directly related solely to his services.

> "Each participant's benefits upon retirement or other separation under the Plan are determined by the ratio of his personal contributions to the personal contributions of all other participants then in the Plan, and are, therefore, directly related to services rendered by each during the period of his participation." (Br. for Appellees 34)

Obviously, to the extent that each retiring participant's contribution is the first factor used to determine stock awards, such awards are "directly related to the services rendered by each." However, this overlooks entirely the effect on the second factor (the total contributions of all participants in the Plan at the moment) of the deaths, discharges, and withdrawals of participants *the same age or younger*, and it ignores completely the slower rate of depletion of the third factor (the block of stock) resulting from the deaths, discharges, and withdrawals of *older* participants. The effect of such deaths, discharges, and withdrawals has already been described in detail (Appellant's Br. 22).

Thus, of the three factors determining stock benefits, only the first (the retiring participant's own contribu-

tions) is "related to services," while the other two factors contain the influences which are illegal precisely because they have no relation whatsoever to the services of the retiring participant.

C) *Appellees Do Not Dispute that the Plan Has the Illegal Features of a Tontine.*

In establishing the illegality of the Penney stock scheme, Appellants discussed five leading cases in which analogous schemes with tontine features have been held invalid (Appellants' Br. 34-46). To these five significant cases, Appellees devote a scant two and one half pages (Br. for Appellees 24-26).

Walker v. Walbridge *(1934) 151 Misc 329, 271 NYS 473*

This is the case in which the New York court, faced with a plan analogous to the Penney Plan, passed "on the legality of the insurance, the contract, and the note." (271 NYS at page 480). Appellees conclude that this case "merely involved an attempt to make proceeds of a life insurance policy distributable in part to persons having no insurable interest in the insured." (Br. for Appellees 25.) The Penney Plan not only attempts, but does, the very same thing; namely, those fortunate enough to survive to 60 take stock which in part results from the predecease, discharge, and withdrawal of other participants in whom they have no insurable interest.

Appellants also discussed thoroughly four other analogous cases: *Colgrove v. Lowe, Knott v. State, Fuller v. Metropolitan Life Ins. Co., United States Life Ins. Co. v. Spinks* (Appellants' Br. 37, 39, 41, and 43) concerning which Appellees state merely that these cases are "not in point" (Br. for Appellees 25), but they do not explain why.

United State Life Ins. Co. v. Spinks *(1906) 29 Ky L 960, 96 SW 889, petition for rehearing overruled (1907) 126 Ky 405, 103 SW 335, appeal dismissed (1908) 209 US 539, 52 L Ed 917 (Appellants' Br. 43)*

In this case the court had to decide whether under New York Law the defendant company was required, as to Mr. Spinks, to apply not only his "reserve" but also his equitable share of four years of tontine accumulations toward the purchase of paid up insurance. Because said funds could not legally be awarded to surviving policy holders, the court held that they "should in equity go to those who had contributed [them]." (96 SW at page 894).

Appellants contend that this case was held to have "no persuasive force" in a subsequent New York case.

Fenster v. New York Life Ins. Co. *(1946) 188 Misc 909, 910-911, 66 NYS (2d) 871 (Brief for Appellees 26)*

This case was concerned with whether New York Insurance Law, Section 216, required dividend addi-

tions for the year ended March 7, 1944, to be applied toward extending insurance on plaintiff's deceased husband subsequent to the lapse of the policy on September 7, 1943.

The court held that "ascertainment of the divisible surplus and the apportionment of dividends for the policy year ending in 1944 was not required to be had until after December 31, 1943. Insurance Law, § 216" (66 NYS at p. 872). In the *Spinks* case, however, plaintiffs were seeking to apply accumulations which had accrued for four years, defendant company therein arguing that it need not make any distribution until the end of the ten year tontine period. Distribution of a four year accumulation in the *Spinks* case was of "no persuasive force" to require crediting of a dividend in the *Fenster* case before the end of the year in which earned.

The *Walker v. Walbridge* case, supra p. 4, was decided in 1934 in light of present day public policy. In invalidating the tontine, the court made specific reference to Penal Code, Section 992, on illegal wagering contracts (271 NYS at page 482). Appellees, however, tread lightly over that case, seeking comfort instead from listing eight pre-1907 cases in which tontine policies were involved (Br. for Appellees 21). However, in seven of these eight cases, the question of the legality of tontine policies was neither raised by counsel nor considered by the court.

Simons v. New York Life Ins. Co. *(NY Sup Ct, 1885) 38 Hun 309 (Br. for Appellees 21)*

This was the eighth case cited by Appellees. In it, the plaintiff, in 1875, took out a ten year tontine policy on her husband. In 1880 she ceased paying premiums and in 1882, while her husband was living, brought an action *affirming* the contract, alleging a breach thereof, and asking damages for false representations. Incidental to her argument, plaintiff, who neither had sought nor did seek at trial invalidation of the contract, contended it was an illegal wager between herself and the insurance company on the life of her husband. The court, however, refused to decide the wagering issue:

> "Her action is not based on the law against gaming, and she is in pari delicto even if the contract was immoral and void." (p. 316)

When this case was decided in 1885, such defense was available.

Meech v. Stoner (1859) 19 NY 26

However, as Appellants have already shown (Appellants' Br. 62-63), later cases specifically rejected this defense of in pari delicto and treated the statutes for the recovery of wagered property as remedial. Indeed, when setting forth sections in the Penal Code and urging that as criminal statutes they be strictly construed

(Br. for Appellees 26-29) Appellees notably omit any mention of Sections 994 and 1383 (Appellents' Br. 61-62) which specifically encourage recovery by contributors to an illegal scheme.

D) Appellees' Brief Deals Almost Exclusively with Lottery Cases While Ignoring the Broader Wagering Proscriptions.

Appellees urge that the "chance," casualties and unknown or contingent events which affect stock awards in the Penney scheme do not fall under statutory proscriptions. Their arguments are directed almost exclusively to lottery cases, while ignoring the broader, more generic wagering prohibitions. Even if Appellee could succeed in showing the lottery statutes inapplicable, this would affect neither the applicability of the cases condemning tontines, nor the applicability of the broader wagering prohibitions. This is clearly demonstrated by one of the cases cited by Appellees.

In re Dwyer *(Sup Ct, 1894) 14 Misc 204, 35 NYS 884, (Br. for Appellees 39-40)*

Appellees cite this case to show that the lottery laws were held inapplicable to the award of prizes to horse race winners. They neglect to point out, however, that the court observed that the gaming statute (now New York Penal Law, Sections 991 et seq.) "indisputably covers the facts of this case" (35 NYS at page 886).

E) *Even Then, Appellees Fail to Show the Lottery Laws Inapplicable.*

In attempting to evade the applicability of the wagering and lottery prohibitions, Appellees argue as to the "chance" in the Penney scheme: first, that it is mixed with "skill," and, second, that it is "natural" and not "artificial."

1. There is no "skill" involved in surviving fellow participants.

The chance which operates in the Penney scheme is that of the deaths, discharges, withdrawals and other casualties of participants. Just what "skill" is involved in surviving one's fellow participants has not been made clear by Appellees. Nor is it made clear by any of the three cases cited by Appellees for such proposition.

People v. Fallon *(1897) 152 NY 12, 46 NE 296 (Br. for Appellees 33)*

In this case a horse race in which skill determined the awarding of a prize put up by others was held not a lottery or wager, as opposed to "where the stake is contributed by the participants * * * [which] is a race for a mere bet or wager * * *." (46 N.E. at page 297)

People v. Lavin *(1904) 179 NY 164, 71 NE 753 (Br. for Appellees 33)*

In this case a scheme, in which prizes were won by guessing the number of cigars on which taxes would be

collected during a particular month, was held not to involve "skill."

People v. Hines *(1940) 284 NY 93, 29 NE (2d) 483 (Br. for Appellees 33)*

In this case, cited by Appellees in their "skill" argument, a "policy" scheme was held to violate the lottery statutes and justify punishment thereunder even though a particular statute independently proscribed such "policy" schemes. The absence of skill was mentioned by the court in holding the scheme a lottery.

Regardless of whether the existence of skill serves to mitigate against the "chance" in certain sports or intellectual games, there is clearly no "skill" related to the chances for increased stock awards in the Penney scheme. Appellees try to give the impression that wagering and lottery prohibitory laws are applied only to sordid or illegitimate schemes. Their application to insurance as well as to other legitimate forms of business promotion has already been demonstrated (Appellants' Br. 49-53; 56-59).

2. Wagers on "natural" lives are as illegal as wagers dependent on "artificial" forces.

Appellees then argue that the chance for increased stock awards from the deaths, discharges, and withdrawals of fellow participants is "merely a normal business risk in connection with a legitimate enter-

prise" (Br. for Appellees 48), due to "natural" rather than "artificial" causes, and therefore not condemned by New York law and public policy. Two cases are cited in support of this proposition, neither of which is even persuasive, much less decisive, as to the Penney scheme.

United States v. MacDonald *(CCA 7, 1894) 63 Fed 426, cert denied 159 US 260, 40 L Ed 143 (Br. for Appellees 36-37)*

In this case a bond scheme in which maturation benefits were determined by chance was held invalid. In dicta, the court referred to business investments on which the return was dependent on "natural law," such as growth in the value of real estate. It also referred to life insurance as a legitimate investment because it similarly depended upon the "natural law" of a man's life. Appellees quote extensively from this dictum (Br. for Appellees 36-37) and it is palpably wrong— insurance on another's life is justified as an exception to wagering prohibitions only in cases where an insurable interest exists, as has been clearly demonstrated by the New York law and cases (including *Walker v. Walbridge*, already discussed) (Appellants' Br. 32-46).

United States v. Rich *(ED Ill, 1950) 90 F Supp 624, (Br. for Appellees 38-39)*

In this case indictments under the federal statute prohibiting use of the mails for lottery purposes were

dismissed. Defendants were bookies for horse racing. In reaching its conclusion, the court stated that " 'the use of the mails has not been denied to every form of gambling' * * * [60 F 2d 186]" (90 F Supp, at p 630), and that the statute involved did not apply to "a wager on the uncertain outcome of games of skill, or of a horse race, or of an election, wherein natural forces are determinative" (90 F Supp, at pp 628-629).

The inapplicability of this case is patent from the *New York Constitution, Article 1, Section 9,* which indicates that "except pari-mutuel betting on horse races as may be prescribed by the legislature and from which the state shall derive a reasonable revenue for the support of government" wagering on horse races is prohibited in New York. The "artificial" versus "natural" chance argument is an unsound one at best and in any event inapplicable to New York law.

F) Qualification of the Plan for Tax Benefits Does Not Render It Legal.

As one last attempt to insulate the Penney scheme from condemnation under the laws and public policy of New York, Appellees contend that "the approval of the Plan by the Treasury Department is highly persuasive of its validity" (Br. for Appellees 11). The fact that J. C. Penney Company took advantage of the federal tax laws applicable to a qualified plan may involve

certain admissions against interest on the part of the Company, but the approval by the Commissioner is "entirely irrelevent" to the validity of the Plan under state law.

Moore v. Keystone Macaroni Mfg. Co. *(1952) 370 Pa 172, 87 A 2d 295, 298*

> "Appellants raised two additional points which are worthy of consideration. The lower court excluded the defendant's offer of Regulation 111 of the United States Treasury Department, section 29.23(a)-9, which relates to and authorizes a corporation to deduct as a business expense the amount of the salary of an officer which is paid after his death to his widow. We have heretofore in this opinion taken judicial notice of this regulation, although we sustain the action of the court below in rejecting the offer of proof. The fact, if, as we assume, it is a fact, that this was one of the factors which influenced the judgment or discretion of the directors, supports their good faith, but does not give legality to their act. *The fact that a federal tax law may permit a deduction for tax purposes is entirely irrelevant to the question of whether a corporation has the right and the power under the law of Pennsylvania to give away its corporate assets.* Since the good faith of the directors was not questioned, the court's rejection of the testimony as irrelevant was entirely proper." (Emphasis added)

Indeed, the Delaware law governing corporate powers (applicable to J. C. Penney Company, a Delaware corporation, R 92) similarly is not related to approval or disapproval by the Treasury Department.

Frankel v. Donovan, et al *(Del, 1956) 120 A 2d 311, 313*

In this case a stock option plan "complie(d) with Section 218 of the Revenue Act of 1950 [26 USCA (IRC 1939) § 130A]." Nevertheless, the court held the plan invalid under state law upon attack by minority stockholders.

> *Kerbs v. California Eastern Airways, Inc.* (Del, 1952) 90 A 2d 652; reargument den. (1952) 91 A 2d 62

Even if Treasury Department treatment for tax purposes were "highly persuasive," Appellees cite no case dealing with the charges of illegality raised by Appellants in the case at bar.

G) Appellees Erroneously Suggest the Stock Belongs to the Company and Not the Participants.

Appellees do not say so directly, but they imply that the stock really belongs to the Company. Thus, say Appellees, even if the Plan is illegal it should not be held in a resulting trust for participants as "the entire cost of the stock is being paid for by the company" (Br. for Appellees 64). Appellees ignore the express provisions of the Plan, paragraph 16 (R 34) and the Trust, paragraph Fifteenth (R 70) that no part of the funds of the Trust "shall ever revert to the company." These provisions were required to be inserted in order that the Plan qualify under IRC Section 165 (a) (2), thus

enabling the company to deduct its annual contributions as reasonable business expenses *each year,* under the provisions of IRC Sections 23 (a) and 23 (p) (1). (R 270-271)

The purpose of a "qualified" plan is to enable the employer to deduct contributions the year made while not requiring the employee to pay income tax on such benefits until actually received, *whether or not such benefits are vested and nonforfeitable.* New York tax law permits the same result for state tax purposes.

N Y Tax Law, Section 365

N Y State Tax Commission, Reg, Art 119-a and 117

Appellees imply, by citing Rev. Rul. 33, CB 1953-1, 267, 280 (Br. for Appellees 67), that the company contributions to the Plan were not "vested" in employees prior to their reaching retirement age. This is not the case. The "Company" contributions of *profits* to the present Plan, specified by Article 6 (b) (R 22), were "nonforfeitable" because all participants received their proportionate share regardless of the circumstances of leaving the Plan (R 28, 30). Similarly, after September, 1941, dividends on the Penney shares were "nonforfeitable" because all participants received their proportionate share of said dividends regardless of the circumstances of leaving the Plan (R 24, 28, 30).

Schaefer v. Bowers *(CCA 2, 1931) 50 F 2d 689 (Br. for Appellees 67)*

Appellees cite this case to imply that no rights accrue to participants until benefits are actually paid out. The only issue in this case, however, was whether the shares of stock received by a participant at the end of a five-year stock-purchase plan (operating only from 1920-1925) were taxable as income at their value upon receipt or upon the amount of the employer's contributions used as part of the purchase price. The court held merely that, for income-tax purposes, the value upon receipt was proper.

It is interesting to call to the court's attention its own tax treatment of the Penney Company's sale of "expansion stock" to employees. Such sales of expansion stock made to managerial employees in eight of the thirteen years from 1925 through 1937 (R 97) were expressly replaced by the stock-award provisions of the present Plan (Exhibits 2, 55 and 222 (B)).

Hawke v. Commissioner of Internal Revenue *(CCA 9, 1940) 109 F 2d 946*

In this case the Commissioner and the Board of Tax Appeals had refused to permit a purchaser of Penney expansion stock to use the fair market value of such stock when received as its tax basis for purposes of subse-

quent sale. This court reversed, on the grounds that any excess of fair market value over purchase price was income to the purchaser at that time despite the fact that Hawke and "the J. C. Penney Company [erroneously] did not regard the differential as taxable income to the taxpayer" (109 F 2d 950). This court stressed the compensatory nature of such stock plans:

> " 'If it [the resolution authorizing the payment] was not made in recognition of services rendered, it was a misapplication of corporate funds, for obviously the corporation had no interest in giving away the corporate assets. * * * Here there was consideration — indeed, a double consideration, viz., an acknowledgment and reward for services rendered in the preceding year, and a stimulus to continued effort and service in the ensuing year. Upon no other theory could the payments be justified, and it is not necessary nor proper to explore into an unknown field to find some other motive.'
>
> * * *
>
> "It seems to us that there could be no clearer example of a plan to reward employees for outstanding service, and we hold that the differential as to this stock constituted additional compensation." (109 F 2d at p 951).

Similarly, in the present Penney Plan, the company contributions, deducted each year by the Company as compensation under IRC Sections 23 (a) and 23 (p) (1), were earned by the participants at the end of each year in which they accrued. Under the theories of resulting

trust set forth by Appellants (Appellants Br. 60-79), the Trustee holds the shares of stock in a resulting trust for the 1940-1941 participants whose contributions and earnings were used for the purchase thereof.

CONCLUSION

As a general defense of the Plan, the Brief for Appellees is replete with the shibboleth that everything in respect to the Plan and the Trust was done "in strict accordance with the provisions thereof" (Br. for Appellees 54, 56, 62, 63, 64, 66, 70, 5). This attempt to seek immunity and legality by compliance with the provisions of the Plan has little meaning when it is those very provisions which Appellants attack as invalid. Strict adherence to a plan invalid on its face certainly does not redeem it.

In their entire brief, Appellees never challenge the basic demonstration by Appellants that the Penney Plan results in awards of stock (purchased with the contributions and earnings of participants) to surviving participants in amounts increased by reason of the deaths, discharges and withdrawals of fellow participants. The main defense to the impropriety of such method of stock award is the pervading implication that the J. C. Penney Company is a legitimate business enterprise entitled to accomplish in a pension retirement

plan what others may not do in insurance policies or other business programs. Such defense puts the cart before the horse. The Plan is not invalid by virtue of the business enterprise which operates it, nor because of the reasons for which it was established. It is illegal because of the manner in which it operates.

The judgment of the trial court should be reversed, and the Plan, insofar as it relates to the Penney stock, declared invalid under New York law and public policy, and the Trust as to said shares declared void and of no effect. The cause should be remanded to the District Court to supervise the administration of the resulting trust in said shares of stock for distribution to Appellants and other participants, former and present, in proportion as their contributions and earnings were used for the purchase of such stock, and to award Appellants compensation for the reasonable value of the services of their attorneys in the prosecution of this action, and for their costs and disbursements incurred herein.

Respectfully submitted,

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